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Change in Ownership - S. Property

This is in reply to your memo of March 10 in which you ask whether there has been a change of ownership with respect to S. Company under the facts which follow.

Prior to June 16, 1932, F. was the owner of record of 235,514.70 shares of the voting stock of S. Company, which amounted to 28.3 percent of the outstanding shares.

On June- 16, 1932, F. 's brother, Everette, died. At that time, E. and his wife owned, as their community property, voting shares totalling 407,337.53 or 49.9 percent of the outstanding voting stock of S. Company. In his will, E. created two trusts which contained both his and his wife's community property interest in the stock. E. named his brother F. and his daughter B. as co-executors and co-trustees of the trusts. E. 's wife was beneficiary of one trust, and his children and the issue of any deceased child the beneficiaries of the other trust.

In October, 1982, F. and his son, F. S. shifted control of the corporation to themselves by voting to sell 135,294.12 shares of unissued voting stock to F. and by electing F. president of the corporation; The additional shares raised F. 's total record ownership (exclusive of his ownership as a fiduciary) to 420,803.82 shares or 42 percent and shifted majority ownership of the shares from E. family to F. 's family. This power play was apparently made possible by F. 's ability to vote the shares in E. 's estate (or part of them) in his capacity as co-executor or co-trustee.

The question raised by the foregoing facts is whether F. obtained control in S. Company through the transfer of stock to him as a co-executor or co-trustee

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as a result of the death of E . If so, there has been a change of ownership of property under Revenue and Taxation Code Section 64(c).

Corporations Code Section 702(a) provides:

"Subject to subdivision (c) of Section 703, shares held by **an...executor...may** be voted by such holder either in person or by proxy, without a transfer of such shares into the holder's name; and shares standing in the name of a trustee may be voted by the **trustee**, either in person or by proxy, but no trustee shall be entitled to vote shares held by such trustee without a transfer of such shares into the trustee's **name.**"

Section 704 provides in part:

"If shares stand of record in the names of two or more persons, whether fiduciaries, members of a partnership, joint tenants, tenants in common, husband and wife as community property, tenants by the entirety, Voting trustees, persons entitled to vote under a -shareholder voting agreement or otherwise, or if two or more persons (including **proxyholders**) have the same fiduciary relationship respecting the same shares, unless the secretary of the corporation is given written notice to the contrary and 'is furnished with a copy of the instrument or order appointing them or creating the relationship wherein it is so provided, their acts with respect to voting shall have the following effect:

"(1) If only one votes, such act binds all;

"(2) **If** more than one vote, the act of the majority so voting binds all:

"(3) If more than one vote, but the vote is evenly split on any particular matter, each faction may vote the securities in question proportionately...."

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Corporations Code Section 702(a) makes it clear that either an executor or a trustee can vote the shares he holds although a trustee must hold the shares in his name to vote.

Mere F is co-executor and co-trustee with B. Conceivably, B might want to vote the stock differently from F. In such event, Corporations Code Section 704(3) provides that each fiduciary may vote proportionately. In that case, F would be entitled to vote one-half of the shares as a co-executor or co-trustee. As a fiduciary, therefore, F has the right to vote at least 203,668.76 shares of S Company stock. At the time F became co-executor, he was also entitled to vote 235,514.70 shares which he owned of record in his own right. (Corporations Code Sections 185 and 701(d).) Thus, upon becoming co-executor of the estate of E, F became entitled to vote a total of 439,183.46 shares of S Company stock, which shares exceeded 50 percent of the outstanding shares at that time.

For purposes of Section 64(c), control is defined in Section 25105, which states that ownership or control is "Direct or indirect ownership or control of more than 50 percent of the voting stock of the [corporation]...." Although there are no published appellate decisions interpreting Section 25105, the section has been considered in Appeal of Signal Oil and Gas Company, etc., Cal. St. Ed. of Equal., September 14, 1970, a franchise tax case dealing with the question of whether there are circumstances where controlling ownership can exist in the absence of majority ownership. In reaching an affirmative answer, the Board stated:

"In order to obtain guidance for decision of the instant appeal it is necessary to examine provisions of statutes whose purpose and procedure are somewhat analogous to those of the unitary business concept of section 25101. Such similarity is present in sections 24725 and 25102 of the Revenue and Taxation Code which are concerned with clearly reflecting the income of affiliated taxable entities, and authorize the use of allocation of income to accomplish this purpose. The scope of both sections is defined in terms of taxable entities ...owned or controlled directly or indirectly, by the same interests....' (Emphas is added.)

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"In reference to the ownership **or** control required by section 25102, section 25105 of the Revenue and Taxation Code states:

'Direct or indirect ownership or control of more than 50 percent of the voting stock of- the taxpayer shall constitute ownership **or** control for the purposes of this article.'

'Section 482 of the Internal Revenue Code of 1954 is the almost identically worded federal counterpart of section 24725. Treasury regulation section 1.482-1(a)(3) provides in part:

'The term "controlled" includes any kind of control, direct **or** indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise....' (Emphasis added.)

"In Charles Town, Inc. v. Commissioner, 372 F.2d 415, Cert. denied, 389 U.S. 841 [19 L. Ed. 2d 104], two shareholders controlled one of the two relevant corporations but only owned 2 percent of the stock of the **other**. The United States Court of Appeals held that notwithstanding this minority ownership the above stockholders were in effective control of the-latter **company**, and application of section 482 was sustained. A primary source **of this** effective control was found in an agreement executed by the majority shareholder."

- B. Bittker and J. Eustice, Federal Income Taxation of Corporation and Shareholders, (4th Ed. 1979), make the following statement with **respect to** Internal Revenue Code Section 482 at page 15-20:

"One of the necessary ingredients for the application of Section 482 is that the organizations dealing with one another be owned or controlled directly or indirectly,, by the same interests. This aspect of the section,... is of broad and indefinite sweep.

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The use of the disjunctive in stating that either common ownership or common control will support application of the section indicates that the fact of control alone should be sufficient for this purpose. Moreover, the term 'indirectly' suggests that ownership attribution should be relevant in this context. Although it is clear that the full panoply of constructive ownership principles, such as those found in Section 318, should not be imported, the courts, prompted in large part by the statutory reference to indirect ownership and control, have not hesitated to apply attribution principles in determining whether the requisite ownership or control existed in a particular situation."

When F became co-executor of the estate of his deceased brother E, he became entitled to vote more than 50 percent of stock of S Company as previously indicated. While F did not at that time obtain ownership of more than 50 percent of the voting stock, it appears from the material quoted above that the fact of control alone should be sufficient for purposes of Section 25105. The material quoted above further indicates that the meaning of "control" is "broad and indefinite" and that "it is the reality of the control which is decisive." The reality here is that F, through his legal right to vote more than 50 percent of the stock of S Company, obtained control of the Company. This conclusion is evidenced by the facts that F, through his controlling votes, was elected president of the corporation and was able to purchase additional unissued shares sufficient to shift majority ownership from E's family (which held it for many years) to Fred's family.

From all of the foregoing, it is my opinion that F obtained direct or indirect control of more than 50 percent of the voting stock within the meaning of Section 25105 at the time he became co-executor of the Estate of E. Since F obtained control through the transfer of corporate stock occurring as a result of the death of E there was, in my opinion, a change of ownership of property of S Company under Section 64(c).

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